Decision **DRAFT DECISION OF ALJ BUSHEY** **(Mailed 12/19/2005)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Review Policies Concerning Intrastate Carrier Access Charges.	Rulemaking 03-08-018 (Filed August 21, 2003)

FINAL OPINION MODIFYING INTRASTATE ACCESS CHARGES AND CREATING MEMORANDUM ACCOUNT

I. Summary

This decision reduces intrastate access charges[1] by eliminating two non-cost based charges - the network interconnection charge (NIC) and transport interconnection charge (TIC). Local exchange carriers are ordered to record lost revenue in a memorandum account.

II. Background

On October 4, 2001, AT&T Communications of California (AT&T) filed a petition pursuant to § 1708.5[2] seeking a reduction in intrastate access charges, explaining that existing access charges are priced substantially above cost and stifle competition in long distance markets.

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[1] The term "access charges" refers to charges imposed by local exchange carriers for use of the local network by interexchange or long distance carriers, who use this switched access to originate and terminate long distance calls to the vast majority of California residential and business customers.

[2] All section citations are to the Public Utilities Code, unless otherwise indicated.

Pacific Bell Telephone dba SBC California (SBC), Verizon California Inc. (Verizon), a group of small local exchange carriers, and Roseville Telephone Company, which has since changed its name to Surewest Telephone, opposed AT&T's petition primarily on the grounds that access charges are set at levels to subsidize local service.

The Commission granted AT&T's petition and found that since setting access charges in 1994, the local exchange carriers had started offering long distance services in direct competition with the long distance carriers, such as AT&T. When providing long distance service, however, the affiliated long distance carriers did not incur access charges but only made paper transfers of such fees to their affiliated local exchange carriers. In contrast, independent long distance carriers incurred charges for access. To the extent access charges exceeded the local exchange carriers' costs, these charges prevented fair competition in the long distance markets because the charge to independent carriers exceeded the "cost" incurred by the local carriers and their affiliates. Consequently, independent long-distance carriers suffered a "price squeeze" because they had to pay actual funds to an unrelated third party.

In R.03-08-018, the Commission also noted that certain components of the access charges are not cost-based or associated with the costs of any specific transport function, but made no finding whether intrastate access charges were too high to permit long distance carriers to compete with SBC and Verizon in long distance markets. The scope of this proceeding, however, was limited to review of the NIC and TIC components of access charges.

In the decision resolving the first phase of the proceeding, Decision (D.) 04-12-022, the Commission decided that should it authorize local exchange carriers to decrease access charges, these carriers would also be authorized to offset any decrease in access charge revenue with comparable increases in revenue for local services. The Commission also decided to examine mid-size and small local exchange carriers' access charges in a subsequent phase of this proceeding.

SBC, Verizon, and MCI WorldCom Network Services, Inc. (MCI) and Qwest Communications Corporation (Qwest) submitted initial testimony on the Phase II issue of whether the non-cost-based elements of the access charges should be modified. AT&T, Sprint Communications Company (Sprint), Qwest, MCI, and Verizon provided responsive testimony. The Utility Reform Network (TURN) and the Office of Ratepayer Advocates (ORA) jointly filed and served comments responding to the initial testimony.

On November 18, 2005, the Commission approved the application of SBC and AT&T for authority to transfer control of AT&T Communications of California and its related California affiliates from AT&T to SBC, with the resulting entity doing business as AT&T. The merger created the largest telecommunications firm in the United States.

Also on November 18, 2005, the Commission approved a similar merger between Verizon and MCI in D.05-11-029.

III. Non-Cost-Based Elements of Access Charges

Verizon's access charges include TIC and SBC's access charges include NIC. The history and derivation of these charges is discussed in D.04-12-022, and need not be repeated here. No party disputes that these charges are not based on cost, and are assessed on a per-minute basis for all long-distance calls originated or terminated by a local exchange carrier for a third-party long distance carrier.

In D.04-12-022, we also discussed the undesirable effect of excessive access charges on competition where not all market participants are subject to the charges. Changes in California's telecommunications market, namely the mergers of the two largest local exchange carriers with the two largest long distance carriers, discussed above, and the local exchange carriers' entry into the long distance market, have greatly diminished the fraction of the long distance market actually paying the access charge to an unaffiliated entity. To the extent access charges are set above cost, local exchange carriers and their affiliates have an opportunity to price long distances services at levels that are anti-competitive. This could occur by charging high access fees to independent competitors while incurring much lower actual costs to provide the same access service to themselves or an affiliate. In this way, a local exchange carrier and its affiliates could offer unfairly low long distance rates and drive competitors out of business. This effect is called "predatory pricing."

IV. Positions of the Parties

The January 25, 2005, scoping memo listed four issues that would be addressed in Phase II of this proceeding. The parties' positions on each issue are set out below:

A. Whether to reduce or eliminate the NIC and TIC portions of access charges

ORA and TURN oppose eliminating the non-cost-based components of the access charges because the Federal Communications Commission (FCC) is considering revisions to its intercarrier compensation regime which could render unnecessary or be inconsistent with the changes proposed in this docket. ORA and TURN also pointed to the then-pending SBC-AT&T and Verizon-MCI mergers as dissipating the urgency to eliminate the non-cost-based elements of access charges.

All other parties supported eliminating these portions of access charges.

B. SBC and Verizon Revenue from NIC and TIC

No party disputed SBC's and Verizon's representations of NIC and TIC revenue in 2004. The reported amounts are shown below.

	2004 Revenue
SBC	$132.0 million
Verizon	$ 43.2 million

C. Appropriate Ratemaking for Recovery of Lost Revenues if NIC and TIC are Eliminated

Verizon argued that actual data, rather than forecasts, should be used to determine its lost revenue, which would vastly simplify the ratemaking process by removing a significant source of controversy and uncertainty. Verizon proposed to use its Schedule A-38 surcharge as a mechanism to assess the needed revenue increase, $43.2 million, to its local billing base. Verizon noted that the Commission has previously used the Schedule A-38 surcharge as a means to implement similar, minor price changes, including the annual price cap filings and exogenous factor adjustments.

SBC also proposed to use 2004 actual revenue from its non-cost-based access charge element as the amount to be re-allocated to local customers. SBC stated that predicting such lost revenues for future years would be a function of access line market share and consumer calling patterns, which would require a contentious proceeding to resolve. Like Verizon, SBC recommended that its lost revenues be recovered through permanent increase to its Rule 33 Surcharge in the amount of $132.0 million.

Sprint, Qwest, and AT&T took no position on the ratemaking proposals.

ORA and TURN agreed, for purposes of this proceeding only, that actual data rather than forecasts should be used for ratemaking. ORA and TURN, however, opposed SBC's and Verizon's proposal to use 2004 data to permanently increase surcharge revenues.

ORA and TURN stated that SBC has conceded that revenue from the NIC and TIC charges has been declining, and is expected to continue to decline. ORA and TURN opposed locking in 2004 lost revenues in perpetuity. Instead, ORA and TURN propose that the amount decrease by 5% or 10% per year until the amount is zero.

Verizon opposed ORA and TURN's proposal and contended that revenue rebalancing should be done on a test year basis, and that its local calling base is declining so the actual amount recovered will decline over time. SBC did not respond to the proposal.

D. Should the Commission Take Steps To Ensure That Long Distance Customers Receive The Benefit of Lower Access Charge?

With the exception of ORA and TURN, all parties opposed the Commission mandating that long distance companies decrease prices to reflect lower access charges. The agreeing parties contended that the competitive marketplace would provide a better and more efficient means to address these cost savings.

ORA and TURN urged the Commission to require long distance carriers to pass through any access charge reductions to their customers. ORA and TURN argued that without mandated price reductions, the long distance carriers will benefit from these cost reductions, not customers. ORA and TURN pointed out that with the now-approved mergers, the two largest local exchange carriers will absorb the two largest independent long distance carriers, and thus absorb the benefits of the cost reduction. These same local exchange carriers will also benefit from a rate increase to offset the lost NIC and TIC revenues. ORA and

TURN concluded that, absent Commission action to require price reductions, this double benefit will occur.

V. Discussion

Fair competition in the long distance market is a long-standing goal of this Commission. Our purpose in opening this rulemaking was to evaluate AT&T's contention that long distance carriers were being subject to a "price squeeze" by local exchange carriers offering long distance service. AT&T argued that independent long distance carriers paid above-cost access charges, while the local carriers' long distance affiliates made only "paper transfers." See R.03-08-018. Since that time, however, AT&T has merged with SBC and has, in effect, joined the affiliates of which it complained. Verizon and MCI have similarly merged.

For many well-articulated reasons, all parties agree that access charges should be based on costs, and that the NIC and TIC elements of access charges are not based on costs. As a conceptual matter, no party supports continuing these cost elements, although ORA and TURN recommend that we maintain the status quo pending final actions by the FCC.

We agree with the parties that the NIC and TIC should be eliminated. Ensuring fair competition requires that access charges closely follow actual costs. The NIC and TIC are not consistent with this requirement, and we eliminate this component of access charges.

No party disputes SBC's and Verizon's estimates of 2004 revenues from the NIC and TIC. SBC and Verizon would have this amount added to their respective overall surcharges on an annual basis indefinitely.

In D.04-12-022, we concluded that if we reduce or eliminate access charges for SBC and Verizon, then we should order "offsetting rate increases." See Conclusion of Law 2. While dollar-for-dollar offsets were not required, we contemplated a reasonable approximation of on-going revenue deficiencies, consistent with our rate rebalancing history. See, e.g., *Universal Service and Compliance with the Mandates of Assembly Bill 3643*, 68 CPUC2d 524, 630 (D.96-10-066) (ordering local exchange carriers to reduce other rates to offset high cost subsidy amounts, and setting up memorandum account to true up actual amounts).

The record in this proceeding, however, shows that all parties are adverse to forecasting lost revenue, and that current trends show overall access charge revenue decreasing. To avoid forecasting contentiousness, Verizon and SBC propose to use actual 2004 data. ORA and TURN do not oppose starting with 2004 data, but suggest building in a 5% or 10% annual reduction, which SBC and Verizon in turn oppose.

Due to the significant changes in the long distance market, most notably the mergers, we find that 2004 data is not reasonably representative of the expected future. We also find that a reasonable estimate should reflect the conceded declining revenue from access charges.

Given the unpredictable marketplace, we conclude that obtaining reasonable forecasts of lost revenue from eliminating NIC and TIC would require substantial resources of the parties as well as the Commission. Such expenditure of resources is not justified in light of the amount likely to be at issue.

Therefore, we will adopt a ratemaking methodology based on actual recorded lost revenue. In this way, we will avoid the need for forecasts and the data will reflect any market changes. SBC and Verizon will be allowed to accrue interest on the recorded amounts due to the delay in recovery of the lost revenues.

SBC and Verizon are authorized to create a memorandum account in which to record all revenue that would have been realized from NIC and TIC access charges to unaffiliated long distance carriers. Such amounts shall be recorded monthly and shall be subject to audit by the Commission staff. SBC and Verizon shall accrue interest on the amounts recorded in their respective memorandum accounts at the 90-day commercial paper rate. SBC and Verizon are authorized to seek recovery in their next annual price cap filings of all such properly recorded revenue amounts, plus interest, in their Rule 33 Surcharge (SBC) and Schedule A-38 Surcharge (Verizon).

In D.04-12-022, we indicated that we would consider changes to access charges of the local exchange carriers, other than SBC and Verizon, in a third phase of this proceeding. These non-SBC or Verizon entities include small rural exchange carriers,[3] Frontier companies,[4] Surewest Telephone, and the competitive local exchange carriers. The Commission uses different procedural mechanisms to review the rates and charges for each of these types of entities. The small rural exchange carriers usually file either CHCF-A general rate cases via the advice letter process. Frontier-Citizens Telecommunications Company of California and Surewest have annual price cap filings and review similar to SBC

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[3] Calaveras Telephone Company, Cal-Ore Telephone Company, Ducor Telephone Company, Global Valley Network (Evans Telephone Company), Foresthill Telephone Company, TDS-Happy Valley Telephone Company, TDS-Hornitos Telephone Company, Kerman Telephone Company, Pinnacles Telephone Company, Ponderosa Telephone Company, Verizon-WestCoast, Sierra Telephone Company, Inc., Siskiyou Telephone Company, Volcano Telephone Company, TDS-Winterhaven Telephone Company, and Century Telephone of Oregon.

[4] "Frontier companies" include Citizens Telecommunications Company of California, Inc., Citizens Telecommunications Company of the Golden State (a small rural exchange carrier), Citizens Telecommunications Company of Tuolumne (a small rural exchange carrier), Frontier Communications Company of America, and Electric Lightwave, Inc.

and Verizon. The competitive carriers are not required to provide cost support for their services and have flexible pricing rules.

To implement our policy that access charges should not include non-cost-based elements, we direct Surewest and Frontier-Citizens Telecommunications Company of California to follow the same requirements set out above for SBC and Verizon. We order all small rural exchange carriers and the competitive local exchange carriers to submit any modifications necessary to conform their access charges to the policy announced in today's decision; such filings shall be made within 30 days of the effective date of today's decision.

The small rural exchange carriers, including Frontier-Citizens Telecommunication Companies of Golden State and Tuolumne, are authorized to seek recovery for revenue requirement shortfalls resulting from the elimination of these access charge elements in their next annual CHCF-A advice letter filing or their next general rate case filing, whichever is appropriate. CHCF-A advice letter filings shall be consistent with applicable eligibility criteria (*see* D.88-07-022, 90-12-080 and 91-05-016). Small rural exchange carriers shall also provide in their next CHCF-A annual filing or their next general rate case filing, their 2005 total recorded access minutes and seven-months recorded 2006 access minutes annualized (or full year recorded for those filing a general rate case) to support their request for revenue requirement recovery associated with the lost revenues due to the elimination of the access charge rate elements.

Finally, we are persuaded that the competitive market will effectively entice long distance carriers to reduce prices due to reduced access costs. We, therefore, will not order any reductions in long distance rates.

VI. Conclusion

Our primary objective in this proceeding is to assure California long distance markets remain competitive and working to the benefit of California customers. This order resolves the questions set forth in R.03-08-018 and eliminates non-cost-based rate elements from access charges. Due to the substantial unpredictability of future access charge revenues, we authorize SBC and Verizon, as well as Surewest and Frontier-Citizens Telecommunication Company of California and the small rural exchange carriers, to record in a memorandum account the amount of non-cost-based revenue they would have collected from unaffiliated entities.

VII. Hearings Are Not Required

No hearings are necessary as there are no disputed issues of material fact.

VIII. Comments on Draft Decision

The Commission mailed the draft decision of ALJ Bushey in this matter on _________, 2005, in accordance with Section 311(g)(1) of the Public Utilities Code and Rule 77.7 of the Rules of Practice and Procedure. Parties filed comments on _________, 2005, and filed reply comments on _________, 2005.

IX. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and Maribeth A. Bushey is the assigned ALJ in this proceeding.

Findings of Fact

1. SBC's and Verizon's access charges include rate elements which are not based on cost.

2. The estimates of 2004 TIC and NIC revenues provided by Verizon and SBC are not reasonable forecasts of on-going revenues from these access charge elements.

Conclusions of Law

1. No hearings are necessary.

2. The NIC and TIC rate elements of access charges should be eliminated.

3. SBC and Verizon should recover actual lost revenue from unaffiliated entities caused by suspending the NIC and TIC elements.

4. Frontier-Citizens Telecommunications Company of California and Surewest should follow the same procedures as adopted for SBC and Verizon.

5. The rural local exchange carriers and the competitive local exchange carriers should make appropriate regulatory filings to exclude any cost elements similar to the NIC and the TIC.

6. The rural local exchange carriers should be authorized to recover any revenue requirement shortfalls caused by eliminating non-cost-based elements from their access charges.

7. This decision should be effective immediately.

FINAL ORDER

IT IS ORDERED that:

1. Pacific Bell Telephone Company dba SBC California, Inc. (SBC) shall eliminate the network interconnection charge element of its access charges with an advice letter filing no later than 30 days after the effective date of this decision.

2. Verizon California Inc. (Verizon) shall eliminate the transport interconnection charge element of its access charges with an advice letter filing no later than 30 days after the effective date of this decision.

3. SBC and Verizon are authorized to establish a memorandum account and to record in such account any actual lost revenue in each year from unaffiliated entities due to the suspensions in Ordering Paragraphs 1 or 2, respectively. Recovery of the amounts so recorded may be sought through the annual price cap Advice Letter filings set out above. SBC and Verizon are authorized to make subsequent annual filings to reflect the previous year's actual recorded lost

revenue due to the suspensions of the network interconnection charge or the transport interconnection charge element of intrastate access charges from nonaffiliated entities only.

4. Surewest Telephone and Frontier-Citizens Telecommunications Company of California, Inc. shall follow the same procedures as set forth in Ordering Paragraphs 1-3 to conform their access charge rate elements to the policy set forth in this decision with an advice letter filing no later than 30 days after the effective date of this decision.

5. Calaveras Telephone Company, Cal-Ore Telephone Company, Ducor Telephone Company, Global Valley Network (Evans Telephone Company), Foresthill Telephone Company, TDS-Happy Valley Telephone Company, TDS-Hornitos Telephone Company, Kerman Telephone Company, Pinnacles Telephone Company, Ponderosa Telephone Company, Sierra Telephone Company, Inc., Siskiyou Telephone Company, Volcano Telephone Company TDS-Winterhaven Telephone Company, Century Telephone of Oregon, Frontier-Citizens Telecommunications Company of the Golden State, Frontier-Citizens Telecommunications Company of Tuolumne and Verizon-WestCoast shall conform their access charges to the policy set forth in this decision with an advice letter filing no later than 30 days after the effective date of this order, and may establish a memorandum account as set forth in Ordering Paragraph 3. These carriers may seek recovery of any resulting revenue requirement shortfalls in their next annual CHCF-A advice letter filing or general rate case filing, whichever is applicable.

6. No hearings are necessary for this proceeding.

7. Rulemaking 03-08-018 is closed.

This order is effective today.

Dated ________________, at San Francisco, California.